IN THE

SUPREME COURT OF THE UNITED STATES

No. 292 October Term, 1944.

MUTUAL FIRE INSURANCE COMPANY OF GERMANTOWN,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

The petitioner by its counsel hereby prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above cause on April 28, 1944, affirming the judgment of the United States District Court for the Eastern District of Pennsylvania.

OPINIONS BELOW.

The opinion of the United States District Court for the Eastern District of Pennsylvania appears pages 104a-

129a of the record and is reported in 50 Fed. Supp. 665. The opinion of the Circuit Court of Appeals for the Third Circuit appears at page 160 of the record and is reported in 142 Fed. (2d) 344. (Advance Reports June 26, 1944.)

JURISDICTION.

The original judgment of the Circuit Court of Appeals for the Third Circuit was entered April 28, 1944 (R. p. 169). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED.

1. Is a mutual fire insurance company required by the statutes of the state of its incorporation to hold its surplus as a reserve for the payment of losses and expenses until dissolution, to be denied exemption under Section 101 (11) of the Revenue Act of 1938 solely because in compliance with the terms of said statute it does not return the excess of premium over cost to the policyholder during the policy year?

2. The alternative question presented is whether petitioner, if not exempt under Section 101 (11) of the Revenue Act of 1938, is a mutual insurance company other than life and marine which is entitled to be taxed as such insurance company under the provisions of Section 207 of the Revenue Act of 1938 and thereby entitled under Section 207 (c) (3) of that Act to deduct from gross income the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves.

STATUTES INVOLVED.

The pertinent provisions of the Revenue Act of 1938 (the applicable Act) are as follows:

Sec. 101—EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this title—

"(11) Farmers or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses;"

Sec. 207 MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

"(a) Imposition of Tax.—

(1) In General.—There shall be levied, collected and paid for each taxable year upon the special class net income of every mutual insurance company (other than a life insurance company) a tax equal to 16½ per centum thereof.

(2) Foreign Corporations.—The tax imposed by paragraph (1) shall apply to foreign corporations as well as domestic corporations; but foreign insurance companies not carrying on an insurance business within the United States shall be taxable as other foreign corporations.

(b) Gross Income.—Mutual marine-insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(c) Deductions.—In addition to the deductions allowed to corporations by section 23 the following

deductions to insurance companies shall also be allowed, unless otherwise allowed—

(1) Mutual insurance companies other than life insurance.—In the case of mutual insurance companies other than life insurance companies—

(A) the net additional required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and

(B) the sums other than dividends paid within the taxable year on policy and annuity contracts.

(2) Mutual marine insurance companies.—In the case of mutual marine insurance companies, in addition to the deductions allowed in paragraph (1) of this subsection, unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(3) Mutual insurance companies other than life and marine.—In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves."

The pertinent Pennsylvania statute, being the Act of May 25, 1921, P. L. 1124, reported in Volume 40, Purdon's Statutes, Sections 675, 676, and 677, is as follows:

"Permitting certain domestic mutual fire insurance companies to issue cash premium policies without assessment liability; and providing for the distribution and escheat of the surplus of certain domestic mutual fire insurance companies in event of dissolution.

Section 1. Be it enacted, &c., That any domestic mutual fire insurance company, organized prior to May first, one thousand eight hundred and seventy-six, having a surplus not less than the minimum capital required for the organization of a domestic stock fire insurance company and an unearned premium reserve computed upon the same basis as that required of domestic stock fire insurance companies, may issue policies for a cash premium without any contingent liability for assessment.

Section 2. Any domestic mutual fire insurance company, incorporated by a special act of the Legislature prior to May first, one thousand eight hundred and seventy-six, and having a surplus and unearned premium reserve as required in section one, and whose charter provides for a premium deposit which shall remain as a pledge for the performance of the depositor's covenants, which deposit, under the provision of such charter, shall be returned to the depositor at the expiration of the policy, together with a proportional dividend of the profits after deducting losses and incidental charges, and whose charter further provides that the net profit, arising by interest or otherwise, shall be ascertained yearly to every member in proportion to his, her, or their deposit for which each member shall have credit on the company's books, payable at the cancellation of the policy, may, instead

of collecting such deposit money as above provided under such charter, charge a cash premium in advance, on which no dividend or return shall be due or accrue, other than return premiums on canceled policies.

Section 3. The surplus of any domestic mutual fire insurance companies issuing policies in accordance with the provisions of section one or two of this act shall be held as a reserve for the payment of losses and expenses; and, in the event of dissolution of the company, shall be divided pro rata among the policyholders whose policies are in force at the time of dissolution, but no policyholder, other than loss claimants, shall receive more than the amount of the unearned cash premium last paid to the company for the current term of such policy. Any balance remaining shall escheat to the Commonwealth of Pennsylvania.

APPROVED—The 25th day of May, A. D. 1921.
WM. C. SPROUL.

STATEMENT OF FACTS.

The petitioner is a mutual fire insurance company organized by special act of the Pennsylvania legislature. Its business is restricted to the counties of Philadelphia, Bucks, and Montgomery. It has always operated as a mutual fire insurance company. Each insured is a member of the company during the life of his policy and only policyholders can vote. The management has always been vested in a Board of Directors selected annually by the policyholders.

Under its charter and amended charter it is authorized to write insurance on the note plan, perpetual, or for a term of years, and by statute is specifically limited to writing insurance on the mutual plan (Act of May 17, 1921, P. L. 682, Sec. 202 (1) (d)). The standard forms of policies prescribed by the laws of the Commonwealth

of Pennsylvania were adopted by the company, subject to the addition of such provisions as might be necessary under its by-laws or required under the laws of the Commonwealth as they pertain to mutual fire insurance companies.

Petitioner under its amended charter became subject to Section 201 (c) of the Act of May 17, 1921, P. L. 682, which refers to "mutual insurance companies of any kind other than mutual life insurance companies." Under that Act mutual insurance companies may issue policies for a cash premium if certain requirements are met. This same provision appears substantially in the Act of May 25, 1921, P. L. 1124, with the addition that such policies may be written without contingent liability for assessment.

Under the latter Act petitioner must hold its surplus as a reserve for payment of losses and expenses. On dissolution, any balance after payment to policyholders of amounts equal to their unearned premiums, escheats to the Commonwealth of Pennsylvania. Petitioner has never had any capital stock and its business has always been vested in its policyholders.

Petitioner filed its federal income tax return for 1938 under Section 207 of the Revenue Act of 1938. It took a deduction for premiums retained for the payment of losses and expenses for the period June 8, 1938, to December 31, 1938. Petitioner has always contended that it was taxable under Section 207 or corresponding sections of prior revenue acts. Due to the insistance of the Bureau, however, made in this specific case for the year 1934 and prior thereto, petitioner had regularly filed its tax returns under Section 204, which applies to "insurance companies other than life or mutual."

The National Industrial Recovery Act of 1933 imposed an excise tax on the declared value of the capital stock of every domestic corporation carrying on or doing business, which did not apply to insurance companies subject to tax under Sections 201 or 204 of the Revenue Act

of 1932. Since the Bureau had ruled that petitioner was taxable under Section 204, it claimed exemption from tax under the National Industrial Recovery Act.

In 1935 the Commissioner ruled that petitioner was not taxable under Section 204, but was taxable under Section 207. Petitioner thereupon filed claims for refund for the years 1932, 1933, and 1934. Subsequently it filed its returns for the years 1935 and 1936 under Section 207.

In 1937 the Commissioner reversed his ruling and held petitioner taxable under Section 204. The claims for refund were disallowed and additional assessments made for 1935 and 1936. Petitioner filed its return for 1937 under Section 204.

For 1938, however, petitioner filed its return under Section 207 and took a deduction then for the period from June 8, 1938, to December 31, 1938, for premiums retained for the payment of losses and expenses on the theory that it became taxable under Section 207 after June 8, 1938, by reason of its acceptance of the provisions of the Insurance Code through the amendment of its charter.

The total amount of premiums retained for 1938 was $51,101.39. The amount claimed as a deduction for the period from June 8 to December 31, 1938, was $28,840.78. The Commissioner disallowed this deduction and assessed an additional tax of $5,620.93, which arose substantially from the disallowance of the deduction of $28,840.78.

Petitioner filed claims for refund, claiming, first, that it was a mutual fire insurance company exempt from tax under Section 101 (11); that, if not exempt, it was a mutual company for the entire year 1938 taxable under Section 207 and that if it was not so subject through the entire year 1938, it became subject to tax under that section after June 8, 1938. These claims for refund were disallowed and such disallowance formed the basis for the present proceedings.

SPECIFICATION OF ERRORS TO BE URGED.

1. The court below erred in holding that petitioner was not a mutual fire insurance company exempt under Section 101 (11) of the Revenue Act of 1938.

2. The court below erred in failing to hold that petitioner was a mutual insurance company other than life, subject to be taxed under Section 207 of the Revenue Act of 1938.

3. The Court below erred in holding that a deduction for premium deposits retained for the payment of losses and expenses constituted a double deduction under Section 207 (c) (3) of the Act above cited.

REASONS FOR GRANTING THE WRIT.

1. The court below has failed and refused to apply the rule of law established by the Supreme Court of the United States and applied by other Circuit Courts to the effect that when a taxing act is silent on the definition of the subject matter to be taxed, the local state law must determine what constitutes such subject matter.

2. The decision of the court below is in conflict with a decision of the First Circuit in *Commissioner v. National Grange Mutual Liability Co.*, 80 Fed. (2d) 316 (1935) and with a decision of the Sixth Circuit in *Ohio Farmers Indemnity Company v. Commissioner*, 108 Fed. (2d) 665 (1940), and is likewise in conflict with previous decisions of the Third Circuit in *McLaughlin v. Philadelphia Contributionship for Insurance of Houses From Loss by Fire*, 73 Fed. (2d) 582 (1934), and *Driscoll v. Washington County Fire Insurance Co.*, 110 Fed. (2d) 485 (1940).

3. The court below has decided an important ques-

tion of federal law, which has not been, but should be decided by this Court.

4. The decision of the court below has confused the judicial interpretation of Section 207 (c) (3) of the Revenue Act of 1938 and the regulations promulgated thereunder.

ARGUMENT.

THE PETITIONER IS ENTITLED TO EXEMPTION UNDER SECTION 101 (11):

A. THE DECISION OF THE COURT BELOW IS IN CONFLICT WITH THE DECISION OF THE FIRST CIRCUIT IN COMMISSIONER v. NATIONAL GRANGE MUTUAL LIABILITY CO., 80 Fed. (2d) 316 (1935):

Section 101 (11) of the Revenue Act of 1938 exempts from taxation—"Farmers or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses;"

The facts in this case disclose that the petitioner is a mutual fire insurance company. All of its income in excess of that necessary to pay current losses and expenses has been held for the purpose of paying losses or expenses. Such income has been held for that purpose not only in accordance with a well established business policy, but it has also been required to hold such income for the payment of losses and expenses by specific provision of the laws of the Commonwealth of Pennsylvania. The decision of the Court below is predicated on the proposition that because the petitioner did not make distributions to its policyholders, it thereby lost its right to exemption from

taxation. Section 101 (11) on the other hand grants an exemption only to those companies otherwise qualified which use or hold income for the purpose of paying losses and expenses. The Court below held that because the petitioner did not make distribution of its excess earnings to policyholders, it lost its character as a mutual company. This would seem to be inconsistent with the provision of the pertinent section which grants exemption only if income is used or held for the purpose of paying losses and expenses. The decision of the Court below is in this respect in conflict with the decision of the First Circuit in *Commissioner v. National Grange Mutual Liability Co., supra.*

B. THE LAW OF THE COMMONWEALTH OF PENNSYLVANIA MUST DETERMINE WHETHER THE PETITIONER IS A MUTUAL INSURANCE COMPANY.

The important issue in this proceeding is whether a particular mutual insurance company—such as the petitioner—which operates under a state law which by its terms denies it the right to operate so as to furnish insurance to cash premium policyholders at cost, must be denied the privilege of exemption granted to mutual insurance companies under a federal taxing statute solely because of this fact.

The District Court in its opinion concluded that "such a company must accept the consequences which naturally follow from its own course of action in adopting a method of doing business of its own choosing." (R. p. 120a)

The fact is that the provisions of the various acts of assembly of the Commonwealth of Pennsylvania are not of the petitioner's "own choosing." It is the compliance with these various provisions which makes the petitioner a mutual insurance company in the Commonwealth.

The petitioner was organized as a mutual fire insurance company by a Special Act of the Pennsylvania Legis-

lature in 1843. It has conducted its business substantially without change since that date, and for administrative and tax purposes it has always been deemed to be a mutual insurance company by the State of Pennsylvania.

In the Court below, petitioner claimed that it was exempt from income tax under Section 101 (11) of the Revenue Act of 1938, and in the alternative that, if not exempt, it was subject to tax under the provisions of Section 207 of that Act.

Since the Revenue Act of 1918 Congress has taxed "mutual insurance companies other than life" which were not exempt under Section 207.

None of the Revenue Acts has ever defined the term "mutual insurance companies." See *Ohio Farmers Indemnity Co. v. Commissioner*, 108 Fed. (2d) 665, 667 (1940); *Keystone Automobile Club Casualty Company v. Commissioner*, 122 Fed. (2d) 886, 889 (1941).

It must be assumed, therefore, that Congress used the word "mutual" as applied to insurance companies in the sense it had long and generally borne in insurance matters. A mutual company has been generally defined as one in which management is limited solely to policyholders who become members by virtue of their ownership of a policy and whose premiums form the basis for security against losses. See *Ohio Farmers Indemnity Company v. Commissioner*, 36 B. T. A. 1152; *Ohio Mutual Insurance Co. v. Marietta Woolen Factory*, 3 Ohio St. 348, N. S.; *Spruance v. Farmers' and Merchants' Insurance Co.*, 9 Colo. 73, 10 Pac. 285; *Given v. Rettew*, 162 Pa. 638, 640; *and Schimpf & Son v. Lehigh Valley Mutual Insurance Company*, 86 Pa. 373.

In the last cited case the Supreme Court of Pennsylvania stated (page 376):

> "The true principle of mutual insurance is the payment by each of the insured of a certain sum of money towards a *common fund*, which *fund is to be*

held for the protection of each person so contributing." (Italics supplied.)

The Court below erroneously applied a single test seldom referred to either by text writers or local State decisions. It held that because the petitioner did not write insurance at cost, it was not a mutual. It applied this test equally to the petitioner's right to exemption and its right of taxation under Section 207.

Under state law appellant is a mutual company and its character as such should be recognized for federal tax purposes.

The Act of May 25, 1921, P. L. 1124, Section 2 (40 Purdon's, Sec. 676), expressly provides that a mutual insurance company, *without surrendering its mutuality*, may issue policies on a cash premium basis, but when such policies are issued, "*no dividend or return shall be due or accrue other than return premiums on cancelled policies.*"

The federal taxing statutes do not require that insurance be furnished at cost. Are we, therefore, to adopt a definition which does not appear in any of the revenue acts and which, if adopted, would contravene state law and thereby deprive appellant of its legal identity as a mutual company under such law?

In *Metropolitan Life Insurance Co. v. United States*, 107 Fed. (2d) 311, the court said (p. 313):

> "Since the federal statutes do not define the term 'property', or the rights attaching thereto, we must turn to the state law for their meaning. Poe v. Seaborn, 282 U. S. 101, 118, 51 S. Ct. 58, 75 Law Ed. 239."

In the *Poe* case cited in the quotation, supra, it was held that the determination of the State courts that a husband's control over community property under Washington law does not amount to ownership of the entire community property, was binding upon the Commissioner of

Internal Revenue. Upon the Commissioner's argument that this position would result in a lack of uniformity of the taxing statutes in the various states, the court said:

> "The answer to such argument, however, is that the constitutional requirement of uniformity is not intrinsic but geographic (citing cases). And differences of state law, which may bring a person within or without the category designated by Congress as taxable may not be read into the Revenue Act to spell out a lack of uniformity."

An interesting and enlightening discussion of the question here considered is found in *Dayton & Michigan R. Co. v. Commissioner*, 112 Fed. (2d) 627. There the question involved was whether payments of guaranteed dividends on prefered stock were deductible as interest paid on indebtedness within the meaning of Section 23 (b) of the Revenue Act, it being contended that the certificates constituted stock, and not indebtedness. The court held that the law of Ohio on the question was controlling, saying (p. 630):

> "While we look to the federal decisions, and in the absence of such decisions, to the general law, in interpreting the act of Congress, we look to the law of Maryland as laid down by its courts to determine the effect of conveyances executed within that state and relating to property there situate."

These cases are among the most recent setting forth this principle. Others that may be cited in the same vein are:

United States v. Rosebush, 45 Fed. Supp. 664;
Tooley v. Commissioner, 121 Fed. (2d) 350;
Lang v. Commissioner, 304 U. S. 264, (82 L. Ed. 1331);
Helvering v. Stuart, 317 U. S. 154, (87 L. Ed. 109);

Morgan v. Commissioner, 309 U. S. 78, (84 L. Ed. 585);
Freuler v. Helvering, 291 U. S. 35, (78 L. Ed. 634);
Legg v. Commissioner, 114 Fed. (2d) 760;
Plunkett v. Commissioner, 118 Fed. (2d) 644.

What is a mutual insurance company in Pennsylvania can only be determined by the laws of that State. This conclusion is consistent with the authorities upon which appellant relies, holding that in the application of a Federal Revenue Act state law controls in determining the nature of the legal interest which the taxpayer had in the property or income sought to be reached by the taxing statute.

Under the laws of the Commonwealth appellant can exist and be recognized only as a mutual company, for by Section 534 of the Act of May 17, 1921, P. L. 682, (40 Purdon's Sec. 674):

> "No company shall insure upon both the stock and mutual plan, except temporarily as in this section provided."

The Circuit Court recognized the problem confronting it when it said:

> "The taxpayer urges that when the taxing act is silent the local law must determine and that by the law of Pennsylvania it is a mutual fire insurance company. When to apply the local law in construing federal taxing acts and when not to do so is a problem which continues to perplex the courts." (R. p. 162)

It is settled that local laws are determinative if the taxing act so provides, either expressly or by inference:

United States v. Loan & Bldg. Co., 278 U. S. 55 (1928);
Poe v. Seaborn, 282 U. S. 101 (1930).

The lower court, however, relies on *Burnet v. Harmel*, 287 U. S. 103, 110 (1932), for the proposition that the taxing act "is to be interpreted so as to give a uniform application to a nationwide scheme of taxation" and it contends that that admonition "still holds good." It points to the case of *Bowers v. Lawyers Mortgage Co.*, 285 U. S. 182 (1932), as applying general rather than local law in determining whether a taxpayer was an insurance company. The fact is that the Bowers case does not stand for the principle for which it is cited. In that case the company had dropped the word "Insurance" from its name and had extended its charter powers to the purchase and sale of mortgage loans. The so-called "premiums" charged covered agency and other services which generally are not performed under contracts of insurance. Insurance was deemed to be simply an incident of the company's main business. It will be seen that the decision in the Bowers case was based not on the application of general or local law, but on the facts of the case which established that it was not an insurance company.

In the Bowers case it was only held that the fact that an organization is subject to state insurance laws or regulations is not determinative of the question of its taxation under federal statutes. That case held, however, that that fact is significant if other attributes are present.

In the instant case reliance is placed not alone on the fact that the petitioner is chartered as a mutual insurance company, but rather on the fact that in *all* of its attributes *it is* a mutual insurance company under the laws of the Commonwealth of Pennsylvania.

Moreover, the Commonwealth has recognized the fundamental distinction between stock and mutual companies. Mutual companies as distinguished from stock companies

are exempt from capital stock tax, gross premiums tax, and personal property tax. They are, as distinguished from stock companies, not required to file annual reports with the Department of Revenue, and the reports differ materially from those required in the case of stock companies.

Constitutional authority for this distinction is set forth in *Commonwealth v. Girard Life Insurance Company*, 305 Pa. 558, 564 (158 Atl. 262). The Supreme Court of Pennsylvania stated:

> "Both kinds of companies are created by the state and it has always treated them as separate and differing organisms."

Since their organisms are so fundamentally different, Congress in the various Revenue Acts must have legislated with this fundamental distinction in mind. Congress itself has recognized this fundamental difference. In Section 101 (11) certain mutual companies are held to be exempt—"the income of which is used or held for the purpose of paying losses or expenses." By the adoption of the term "used" and "held," Congress recognized that mutual insurance companies either use or hold their income for the purpose of paying losses or expenses. Congress recognized the necessity and the propriety of the creation of reserves for the payment of losses or expenses which might occur in the general operation of the business. The various exemptions from tax granted under Section 101 are calculated to include those companies where no profit inures to any private shareholder or individual. The creation and the retention of a reserve is, therefore, proper because such a reserve is held as a trust fund for the benefit of all members for the purpose of providing protection against future losses.

This doctrine is likewise inherent in Section 207 of the Revenue Act of 1938. In that Section a deduction is

recognized which is an addition to all other deductions allowed by law. A deduction is allowed for premium deposits returned to policyholders and premium deposits retained for the payment of losses, expenses and re-insurance reserve. This deduction is allowable because the amounts so retained cannot be considered to be true profits inuring to the corporation but are by their nature trust funds properly retained for future use in paying losses or expenses. As a matter of fact, under the laws of the Commonwealth, a mutual fire insurance company must provide the capital and reserve required by stock fire insurance companies. This reserve does not constitute income. It is a developed excess, which the members believe is necessary for their own proper protection.

The insistence on "uniformity" in the application of the tax laws of the United States is misguided caution when applied to this case, particularly in the light of Mr. Justice Brandeis' conclusion in *Poe v. Sanborn* (supra) that:

> ". . . The constitutional requirement of uniformity is not intrinsic but geographic. . . . And differences of state law, which may bring a person within or without the category designated by Congress as taxable may not be read into the Revenue Act to spell out a lack of uniformity."

In *Phillips v. Commissioner*, 283 U. S. 589, Mr. Justice Brandeis again considered the question of the requirement for uniformity where the appellant taxpayer raised the question of lack of intrinsic uniformity. He there said (p. 602):

> "The extent and incidence of Federal taxes not infrequently are affected by differences in state laws; but such variations do not infringe the constitutional prohibitions against delegation of the taxing power or the requirement of geographical uniformity."

Thus, to permit the state law to govern the final incidence of the tax does not give the Federal law a construction which would render it invalid under the constitutional requirement of geographic uniformity. See:

Riggs v. Del Drago, 317 U. S. 95, 102;
Harrison v. Northern Trust Co., 317 U. S. 476, 479.

In *Early v. Lawyers Title Insurance Corp.*, 132 Fed. (2d) 42 (C. C. A. 4, 1942), it was held that in determining whether a title insurer, in computing income taxes, could deduct as unearned premiums sums required by Virginia law to be set aside for discharge of the insurer's obligation, the federal court would look to the Virginia law to determine the nature of the insurer's interest in such sums and to federal law only to determine whether such interest was taxable. The court there said (p. 46):

> "The argument is made that to permit the deduction of the reserve set up under the Virginia statute will destroy uniformity in the application of the tax law; but uniformity is not destroyed when the factual basis to which the statute is applied is changed."

Even if we recognize the rule invoked by the Commissioner that an exemption from taxation is not allowed unless clearly within the terms of the statute, we cannot disregard the correlative rule that tax acts always should receive a strict construction in favor of the taxpayer. This latter rule has frequenty been applied in this Circuit:

F. & M. Natl. Bank of Phila. v. U. S., 11 Fed. (2d) 348;
Electric Reduction Co. v. Lewellyn, 8 Fed. (2d) 91;
Rodenbough v. U. S., 25 Fed. (2d) 13.

Before construing the statute in question, we must

bring into view certain applicable and helpful canons of construction, the fundamental one being that courts should ascertain and give effect to the intention of the legislative body.

When because of doubtful language two possible intentions appear, another canon of construction requires that courts shall select the one which is rational and sensible:

> *Scandinavian Belting Co. v. Asbestos Works*, 257 Fed. 937.

In performing this responsible function courts should be careful not to be led astray by definitions of single unrelated words of a statute or by the refinements of lexicographers, but to adhere closely to the use of the words in their commonly understood meaning in immediate relation to their subject matter:

> *Merchants Loan Co. v. Sunetanka*, 255 U. S. 509;
> *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179;
> *Eisner v. Macomber*, 252 U. S. 189.

Particularly in construing a tax act, courts are required to incline most strongly against the government and in favor of the citizen or taxpayer:

> *Gould v. Gould*, 245 U. S. 153.

This rule has been completely disregarded by the court below.

State rules of property must be applied and enforced in proceedings under the revenue statutes in the absence of a conflicting federal law, or constitutional provision on the subject. Differences in state laws so to be applied do not disparage the geographic uniformity of taxation requisite to constitutionality: *Howard v. United States*,

125 Fed. (2d) 986, and cases cited in footnote 33, page 994 of the *Howard case*.

The court below concedes in its opinion that "in no case (that research can disclose) has any court denied a mutual fire insurance company the status of a tax exempt corporation *solely* upon the ground that it did not provide insurance to its policyholders at cost." It points, nevertheless, to several cases in its circuit as "clearly indicating" that insurance at cost is one of the fundamental characteristics of a mutual company.

Upon examination of all of these cases it will be found that the courts in speaking of insurance at cost had in mind, in each, the distinction between a profit-making stock company and a mutual company where no one made a profit, but where the excess of premium was returned to the policyholders in some equitable fashion.

It is submitted that these cases do not stand for an insistence of "insurance at cost" as such, but rather for "insurance without profit" to any incorporators or shareholders who are not also policyholders.

It is submitted that Congress so understood the meaning of a mutual insurance company. Had it intended to specify only those companies supplying "insurance at cost," how simple it would have been to say so in those words rather than in the words used.

There is no specific time fixed by the revenue act or indicated by the court decisions within which the excess premiums must be returned. The important and controlling characteristics of a mutual insurance company are that the policyholders are collectively its owners. No individual, class or group other than the policyholders have any interest in, or power over, it. It has no capital stock and no shareholders. The members, and they alone, are entitled to all dividends, whether resulting from current operations or paid upon dissolution, and whether they are true dividends or only excess premiums paid.

The petitioner in the instant case partakes of all of these characteristics. These are the only characteristics required by the law and the decisions of the Commonwealth of Pennsylvania, and it is submitted that the petitioner should, therefore, be considered a mutual fire insurance company under the Revenue Act of 1938.

THE DECISION OF THE COURT BELOW IS IN CONFLICT WITH THE DECISION OF THE SIXTH CIRCUIT IN OHIO FARMERS INDEMNITY CO. V. COMMISSIONER, 108 FED. (2d) 665 (1940).

In the Ohio Farmers Indemnity Company case the petitioner and its parent, the Ohio Farmers Insurance Company, filed a consolidated return upon the theory that the petitioner had lost its identity as a mutual fire insurance company and had become, in effect, a stock company so that consolidated returns might be filed. The petitioner was a stock company and the Ohio Farmers Insurance Company was a mutual company. The latter company had no capital stock, no shareholders, and each policyholder was entitled to vote. The companies maintained a joint office, with the same officers, directors, employees and agents. Its policies were issued for a cash premium ascertainable and payable in advance, and there was no authority or provision for assessments. Its policies made no provision for payment of dividends and it had made no such payments. The policies were issued on the stock plan only and were the standard forms adopted and used by stock fire insurance companies. It kept its books and records in accordance with the established practices and rules of stock insurance companies on the accrual basis and established a reserve for unearned premiums and reserves for unpaid losses. It was admitted to membership in the National Board of Fire Underwriters, limited exclusively to stock companies, and it subscribed to regular published rates of premium for stock companies. It had made its tax return for the year 1932 and for many

years prior thereto under Section 204 of the Revenue Act of 1932.

If both companies were stock companies, then a consolidated return was permissible, but not otherwise. The Board held that the petitioner's parent was a mutual company and therefore taxable under Section 207. The case was affirmed by the Sixth Circuit, *Ohio Farmers Indemnity Company v. Commissioner, supra.* That Court stated that a mutual company is one in which the distinguishing feature is the mutuality of the corporation, of the members united for that purpose, each taking a proportionate part in the management of its affairs, and being at once insurer and insured, participating alike in its profits and losses, all its members being policyholders, and said:

> "Giving the phrase 'mutual insurance companies' as used in Section 208 of the Revenue Act of 1932, the sense it has long and generally borne in insurance matters, we are of the opinion the Ohio Farmers Mutual Fire Insurance Company is a mutual company and subject to tax under Section 13 of the Revenue Act of 1932 and excluded under Section 204 of said Act." *(1)

The case holds in effect that in determining whether or not an insurance company is a "mutual insurance company" within the meaning of taxing statutes, it must be assumed that the word "mutual" is applied to insurance companies in the sense it has long and generally borne in insurance matters, or, in other words, the term should be given its usual trade significance.

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*(1) Section 208 grants to mutual insurance companies other than life a deduction for premium deposits retained for the payment of losses and expenses. Section 13 is the general taxing section as applied to corporations. Section 204 refers to any insurance companies other than life or mutual.

THE DECISION OF THE COURT BELOW IS IN CONFLICT WITH ITS FORMER HOLDING IN McLAUGHLIN v. PHILADELPHIA CONTRIBUTIONSHIP FOR INSURANCE OF HOUSES FROM LOSS BY FIRE, 73 FED. (2d) 582 (1934), AND DRISCOLL v. WASHINGTON COUNTY FIRE INSURANCE COMPANY, 110 FED. (2d) 485 (1940).

In the *Philadelphia Contributionship* case, supra, the Court stated that Sections 231 (11) and 234 (a) (11) were to be read in pari materia and must be construed together in order to give them their proper effect. *(2)

In that case the Third Circuit stated (p. 584):

> "Revenue Acts have regularly provided for a deduction in the case of mutual insurance companies, that are taxable as an ordinary corporation, of the amount of premium deposits returned to the holders of policies and the amount of premium deposits retained for the payment of losses, expenses and reinsurance reserves. The administrative interpretation of the provisions have been consistent and the Congress has reenacted the provisions in the face of this interpretation some seven times. Regulations 45, Article 572; Regulations 62, 65, 69, Article 571; Regulations 74 and 77, Article 1014.
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> "If we were to hold under the facts of this case that the plaintiff was exempt from taxation under Section 231 (11), it would be the equivalent of holding that Section 234 (a) (11) was useless legislation. But Section 231 (11) was intended to apply to those mutual insurance companies whose sole purpose is to provide protection for its members at cost. In

*(2) Sections 231 (11) and 234 (a) (11) of the 1926 Act are the equivalent respectively of Sections 101 (11) and 207 of the Revenue Act of 1938.

such organizations, the cost of insurance is defrayed by assessments, or payments to meet losses and expenses. The consideration of profits is never involved.

* * * * * * * *

"The plaintiff says that defendant bases its contention on the assumption that it is not a mutual company. But it is plainly such an organization. Both Sections 231 (11) and 234 (a) (11) apply to mutual companies. Only a mutual company which uses or *holds its income* for the *purpose* of paying *losses* or *expenses* is exempt from taxation, but a mutual company which is outside of the purport of that Section may deduct the amount of premium deposits held for expenses and losses or returned to holders of policies."

In *Driscoll v. Washington County Fire Insurance Company*, supra, it was held that taxpayer was not a mutual company. Nevertheless, the Third Circuit stated (page 489):

"Payment of redundancy must be treated as elements of expense deductible from gross income for income tax purposes."*(3)

Under the historical construction of the various Revenue Acts, a distinction has been made between mutual fire insurance companies entitled to exemption and those which were subject to tax. Obviously, Congress did not intend that the same test should be applied under either Section. If this were true, then Section 207 would be useless legislation.

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*(3) Section 207 provides a special deduction for "the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves."

This holding of the Court below will result in judicial and administrative confusion unless this Court decides this important issue of law.

THE QUESTION OF THE RIGHT OF A MUTUAL INSURANCE COMPANY OTHER THAN LIFE TO BE TAXED UNDER SECTION 207 HAS NEVER BEEN BUT SHOULD BE DECIDED BY THIS COURT.

The Court below concluded that "the Trial Judge's finding that the taxpayer does not provide insurance to its members at cost is amply sustained by the evidence. It follows that he correctly held that the taxpayer is not a mutual company within the purport of the revenue act and that it is not entitled to be accorded the status of a company wholly tax exempt." The Court below further held, "In view of our determination that the taxpayer is not a mutual company it must follow that it is not entitled to the special deductions from its gross income allowed only to mutual insurance companies."

The Court below, therefore, predicating its findings solely on the ground that petitioner did not write insurance at cost, decided that petitioner was neither exempt nor taxable under Section 207. Under the architecture of the various Revenue Acts as respects insurance companies, that conclusion does not follow. It ignores the legislative purpose of Section 207.

By the adoption of the terms "used" and "held" as found in Section 101 (11) and "premium deposits retained" as found in Section 207, Congress itself recognized that mutual insurance companies either use or hold their income for the purpose of paying losses or expenses. Congress itself, therefore, in all the Revenue Acts, recognized the necessity and the propriety of reserves for the payment of losses or expenses which can only be created out of excess premium in the general operation of the business.

Likewise, the Laws of the Commonwealth of Pennsylvania contemplate the right of mutual fire insurance companies to create a surplus. See Act of May 25, 1921, P. L. 1124, and Act of May 17, 1921, P. L. 682.

THE DECISION OF THE COURT BELOW HAS CONFUSED THE JUDICIAL INTERPRETATION OF SECTION 207 (c) (3) OF THE REVENUE ACT OF 1938 AND THE REGULATIONS PROMULGATED THEREUNDER.

The Court below held "that the deductions (premium deposits retained for losses and expenses) should be disallowed in any event because the taxpayer had already taken credit for a like amount*(4) as losses and expenses paid during the year."

The Regulations provide (Sec. 19. 207-3) that mutual insurance companies other than life are entitled to the same deductions from gross income as other corporations. This is the deduction which the Court below states has already been taken.

Under the same Regulations (Sec. 19. 207-6) a special deduction is allowed for premiums returned to policyholders or retained for the payment of losses and expenses or reinsurance reserves. This is the deduction claimed by petitioner which has not been taken, nor has it been allowed.

The Regulations provide that losses and expenses are to be charged first against earnings and profits other than premiums to the extent of such earnings and profits.

It is only when a portion of premiums which may have been applied during the taxable year to the payment of losses, expenses, or re-insurance reserves for which the separate allowance is taken under the provisions of Regulations Section 19. 207-3 that that portion so applied may

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*(4) See footnote (6), page 28.

not be deducted. In 1938, as was true in all years*(5), the petitioner was never required to apply any of its premium income towards the payment of losses, expenses, or re-insurance reserves.*(6) The allowance, therefore, of the special deduction which petitioner claims could not be considered to be a double deduction.

The Regulations further provide that if premiums specially deducted are subsequently applied to the payment of losses, expenses, or re-insurance reserves, then such premium so used, and the losses and expenses towards which these premiums have been applied, cannot both be deducted. This is true solely because such premiums retained and applied have been previously taken as a special deduction. Since the petitioner has not taken a deduction for premiums retained, this Section cannot apply.

Under a proper interpretation of the Regulations, the deduction claimed by petitioner as premium deposits retained for the payment of losses and expenses cannot, under the circumstances of this case, be a double deduction. See *Mutual Assurance Society, etc. v. Commissioner*, 24 B. T. A. 1102.

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*(5) Mr. Dill, the accountant witness for petitioner, testified that in every year up to and including 1938 the investment income was always sufficient to pay all current losses and expenses. He testified that it was not necessary for the petitioner to use any of its contingency fund, into which its premium deposits were placed, for the payment of losses or expenses.

*(6) In 1938 petitioner had losses and expenses of $74,098.21. Its net investment income was $80,435.46. Its premium income, which it claims as a deduction, was $51,101.39. It had an underwriting loss in 1938 of $11,436.68.

CONCLUSION.

It is in the public interest both for the purpose of resolving the conflict which exists and for the purpose of a clarification of the law that the issues here presented be determined by an authoritative decision of this Court.

Respectfully submitted,

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